DOW THEORY LETTERS INC.

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THE PICTURE: If 1974 was comparable to 1932 in the stock market (and my charts and statistics suggest that it was), then 1975 is in many ways comparable to the year 1933. In Letter 636 I presented a study of the 1932-33 period from the stock market standpoint. In an earlier Letter (632) I included a study of the 1932-33 period from the economic standpoint. In both cases, the earlier periods were compared with the situation as it stands today.

As I have written so many times before, the stock market was telling us something during the horrendous crash of 1973-74. It was telling us that the nation was moving into a period of economic difficulties and perplexities of the utmost seriousness. After all, a drop of 80% in the unweighted stock averages is comparable to three red flags, a danger signal and a dozen police sirens thrown in for good measure. We've been seeing a good deal of what the sirens and red flags were all about here in 1975.

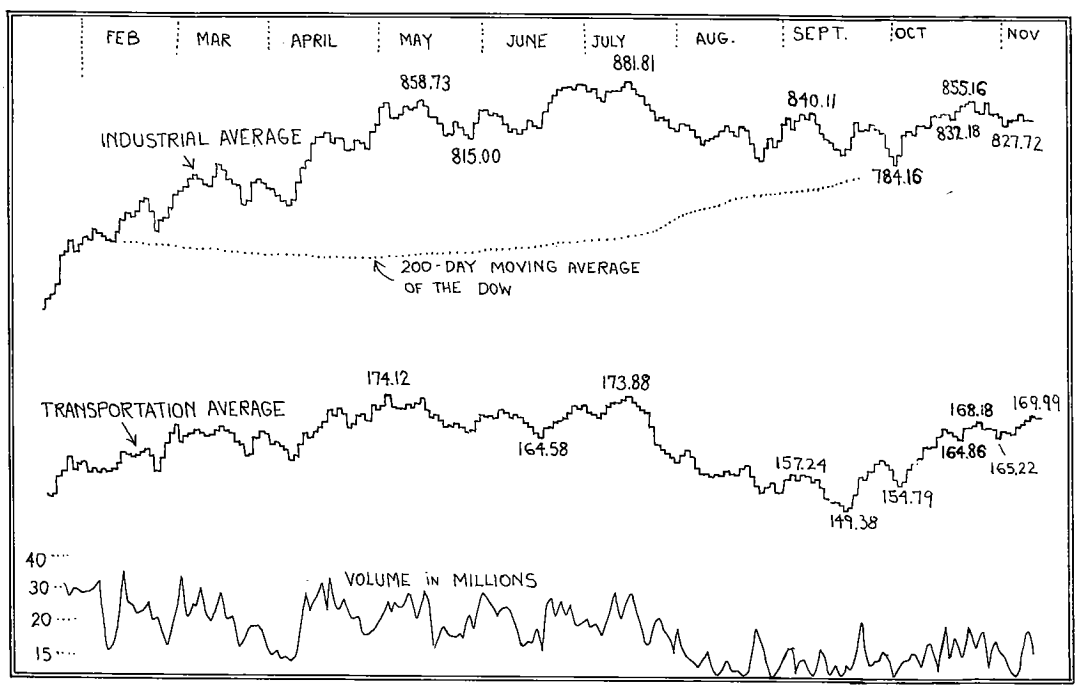
In previous Letters (including the last one) I discussed why I thought the late-1974 lows represented the end of the primary bear market. The 1974 terminal points were the October 3 Transport low of 125.93 and the December 6 Industrial low of 577.60. From the Dow Theory standpoint, as long as one or both Averages hold above the 1974 lows, the primary bull market structure will remain intact.

Now we come to a few current technical problems. From the 1974 lows, the market mounted a major advance. The advance continued into early 1975. The Transports ended their rise on May 5, 1975 at 174.12 (see chart this page). The Industrials concluded their advance on July 14, 1975 at 881.81. Since then we have been in what I term "secondary territory." Secondary territory is that most perplexing of all areas, located under the primary peaks but above the last secondary lows.

From the May 5 peak of 174.12, the Transports embarked on a four-month decline, a decline which hit (what appeared to be) an important bottom at 149.38 on September 16. From their July 14 peak, Industrials went into a two-and-one-half month decline, a decline which ended on October 1 at 184.16.

Next came the most recent rally to the October highs. On October 23 Industrials halted their advance at 855.16, while Transports stopped at 168.18. Wall Street, of course, never makes it easy for those of us who follow it. Obviously, it would have been "so easy and comforting" to have the Average continue up from the lows and push right through the 1975 recovery highs. But the market isn't interested in making things easy for you or for me, and the people who run New York City evidently aren't interested in dropping profits in our laps either.

At any rate, on a cold reading of the Averages we now have two important sets of points to watch. On the upside we have the October 23 peaks of 855.16 for Industrials, 168.18 for Transports. A joint penetration of those levels by the Averages would strongly suggest that the market is on the way to attacking the 1975 highs. On the downside we have the September-October reaction lows of 784.16 and 149.38. A breaking of those lows by the two Averages would be most discouraging and would indicate a further extension of the secondary downtrend.



Question: "Russell, I hear what you're saying, but look at it this way. We had a full secondary reaction. Then on the advance from the September-October lows the Averages failed to better their 1975 highs.

 If the two Averages now turn down and break their secondary lows, wouldn't that be a bear signal? If not, tell me why?"

Answer: On the face of it, if Industrials and Transports penetrate their lows of 784.16 and 149.38 (particularly on increasing volume) we would have the configuration of a primary bear market signal. If that occurred, I would have to decide whether (1) the secondary downtrend was simply extending itself, or (2) whether we had just witnessed one of the shortest (seven months) bull markets in history.

If the September-October lows were broken, I would want to see what the news looked like (whether the market was falling on news or of its own weight). I would also want to see how the technical condition of the market appeared, and I would want to see the nature and manner of the downside penetrations.

While it is always "sweating time" when the Averages stall and then turn down under preceding secondary peaks (as they have been doing since October 16), it is well to note again that under Dow Theory we draw inferences from the action of both Averages, not just from a single Average. During 1934 the Transports (the Rails in those days) broke below their secondary lows and they did not push above their preceding 1933 peak until two years later, until 1936! It's conceivable that we could be going into the same kind of frustrating period now, but only time will tell.

Of particular interest to me is the fact that the Transport Average has been the weaker Average during most of 1975. Transports hit their peak on May 5, more than two months before the Industrial peak (see page 1 chart). BUT, since mid-September the Transports have reversed their role and now appear the stronger Average. On October 1 the Industrials broke to a new reaction low of 784.16, but Transports did not confirm. This positive action set off the advance to the October 23 peaks. At the October peak the Transports were 19 points above their September reaction lows. This represented a rise of 9.0% for Industrials vs. a rise of 12.5% for Transports.

As of this writing, the Transport strength has remained in force, but this strength is not without its technical complications. On Thursday, November 6, the Transportation Average pushed above its earlier (October) high of 168.18 to close at 169.58, but Industrials failed to confirm (see page 1 chart). On Nov. 7 Transports closed at 169.99; again Industrials diverged.

The question now is — are the stronger Transports telling us the "real" story, or are the weaker Industrials giving us the word? Significant sets of points (on the Averages) are so near that it would be well worth while to let the market tell the story, while holding our own guesses or wishes in abeyance. On the upside, it is necessary for the Industrials to confirm the latest Transport move to 169.99, and this means an Industrial bettering of the 855.16 October high. On the downside we have a number of "danger steps" which could be taken by the Transports. The first confirmation of Industrials' weakness (as far as Transports are concerned) would be a breaking of the October 17 Transport low of 164.86. The second Transport danger signal would be a breaking of the earlier 154.79 level. A final really discouraging set of signals (as mentioned earlier) would be a joint breaking of the reactions lows, 784.16 for Industrials, 149.38 for Transports.

I want to stress again that Transports are now about 20 points above their September reaction low of 149.38. This is a great showing of strength, and it would take massive selling pressure, regardless of what Industrials do, to drive the Transports below 149.38. This persistent and stubborn Transport strength is by far the most encouraging factor in the price structure. I would require a total change in the market environment for Transports to turn so weak that they smash the 149.38 level. Such changes, following this kind of recovery, are rare (but obviously not impossible).

Conclusion: The Industrial Average is putting on a "spooky" performance, while Transports hold firm. My work still shows this market to be somewhat overbought, and this may entail a few more "scare sell-offs" and perhaps a few dips by the Dow (even to as low as 800). Nevertheless, my opinion is that the price structure is in a basically strong pattern, and that despite all temporary weakness or shocking news events, the September-October reaction lows will hold. If this is so, the ultimate outcome of this frustrating situation should be a push to new 1975 recovery highs.

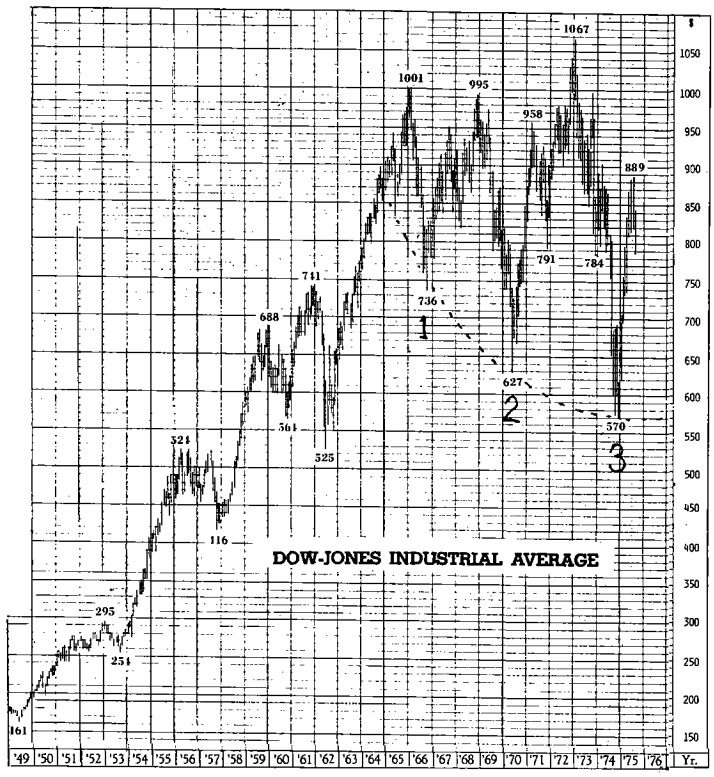
Two Worries: No sooner had I written the piece about negative volume in the last Letter than that index turned down. On November 3rd the NV index broke to a fractional new low. While I would have been happy not to have seen this action, all is not lost. If the NV Index can just move sideways or higher even from its new low it could be that we have established the base for a good double-bottom. All in all, however, until the NV Index acts better, I am treating it as a minus quantity in this market.

The odd lot public has been selling at a frantic rate over the past month, and this has been a solid prop under the market. However, the ratios of selling to buying have been so high on the sell side that I would guess that selling ratios can only decrease (a move towards buying) from here on. Thus, I would say that the odd lot plus for the market is probably nearing an end.

Some Happy Thoughts: The British market (FT Average) hit a new 1975 recovery high on November 6. This I consider a plus for Wall Street. If Britain's crumbling economy can produce a new stock market high, the Dow should be able to do the same.

The D-J 40-Bond Average has had a good recovery from its early October lows. It is currently 1.0 points under its June high of 69.62. The D-J Utility Average (often a bellwether indicator) is also flirting with its 82.89 recent recovery high. A new high for Utilities would be very encouraging.

Another widely-watched market bellwether, General Motors, recorded a new 1975 high on November 5. That must be considered a further plus for Wall Street.



PRIMARY TREND: Many newer subscribers probably wonder why I put so much emphasis on the question of the direction of the primary trend. The answer is at once the simplest and most complex of any having to do with Wall Street. I will try to explain the significance of the primary trend as I see it.

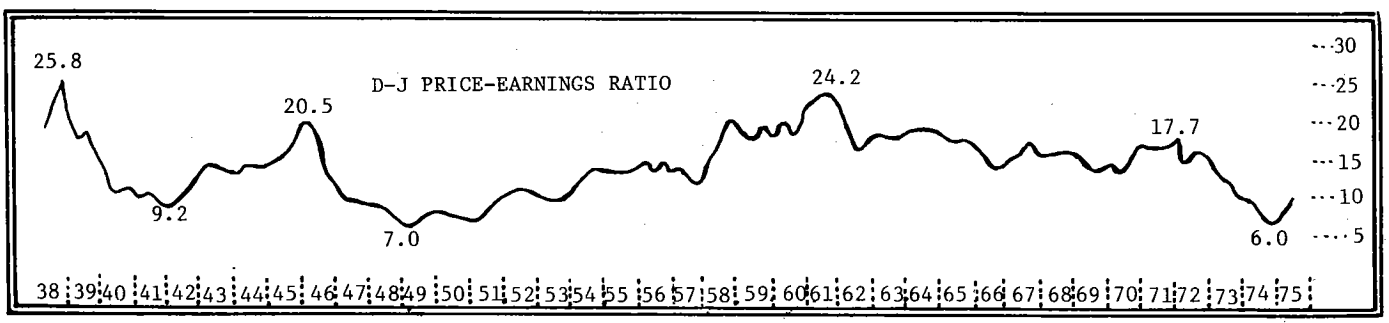
If the primary trend is up (bullish), then the investor has the most powerful force in the market working for him. If for instance the investor buys disadvantageously near a secondary top (during a bull market), then at least he knows that in due time the prevailing primary bull trend will bail him out. If the investor makes his commitments, and shocking news then hits the market, the investors can know that the bull trend (over the longer term) is stronger than the news, and time will take his stocks to new highs. In other words, a primary bull trend is like rising water in a child's bathtub. Regardless of temporary splashes and bursting soap bubbles, the water is fated (in due time) to rise to the top. The rise will take the soap, the brushes, and the toy sailboats with it.

Conversely, a primary bear market is like a bathtub in which the plug has been pulled. The child can romp, turn up the water, make waves, do what ever he likes, but within the hour the water is fated to run out, and all his toys and impliments will then be sitting on the bottom. The comparison with stocks is simple enough. A bear market will erode or smash the vast majority of stocks, regardless of temporary rallies or spates of good news. The bear (as those who lived through 1973-74 well know) plays with the wishers and hopers, then clubs them to the ground when such action is least expected.

The critical question, it follows, is this: "When do we know whether a major bull market or a major bear market is over?" There is no single indicator or method which will provide the perfect, sure-fire answer. One of the standard Wall Street answers (and the best that I know) is that a bull market is over when the Averages have discounted the best that can be seen ahead. By the same token, a bear market has terminated when the Averages fully discount the worst that can be seen ahead.

One of the remarkable (and actually little-studied) phenomenon of the past four decades is the price-earnings cycles for the D-J Industrials. Everyone knows that a price-earnings ratio represents the number of times a stock or an average sells over earnings. But people don't tend to think of P/E ratios in terms of a "confidence gauge." Nor do most investors realize that the big swings in stocks come more from changes in P/E ratios than they do in the actual earnings.

I have drawn a chart of the P/E ratios for the Dow Industrials going back to the year 1938. This chart can show us some interesting facts about the Dow and the P/E ratios going back over the past 37 years. For instance, note that there were three short swings in the P/E's between 1938 and 1949. From the 1938 peak of 25.8 the P/E's dropped to the depressed World War II level of 9.2. The Dow P/E's then rose during the bull market of 1942-46 to 1946's very optimistic peak ratio of 20.5. From the 20.5 high, sentiment turned very depressed, terminating with the 1949 recession low Dow P/E ratio of 7.0.



All of which brings me to the more pertinent part of this discussion. Following 1949 we had two major and very extended swings in the P/E ratio, one up and one down. The 1949-66 bull market began with an extremely low Dow P/E of 7.0. Enthusiasm bloomed as the bull market moved on, and by 1961 (twelve years later) the Dow P/E had climbed to an extraordinary 24.2. That 24.2 reflected the tremendous optimism that greeted the so-called (and widely acclaimed) "soaring sixties." The sixties, however, did not prove to be the financial Nirvana they were advertised to be.

From 1962 to 1966 the Dow pushed upward, but a strange thing happened on the way to the famous 995.15 peak of 1966. The P/E ratios for the Dow actually trended down. By 1966 the P/E's had slid to 13.5, indicating that investors were increasingly skeptical about the quality of the Dow earnings (in other words, despite higher prices, investors were growing cautious).

In February, 1966, the primary bull market topped out, and as you can see on the chart it was mostly downhill for the P/E's after that (despite an upward blip to a 17.7 P/E in 1972).

During 1973 and '74 the market collapsed in what I termed a "slow motion crash." At the 1974 bottom, the Dow Industrial Average recorded a low of 577.60 and an extraordinarily low P/E ratio of 6.0. That ratio was actually below the P/E ratios of both 1942 and 1949! Investors had finally turned dead-bearish, and in 1974 they were giving the Dow the lowest P/E multiple within modern memory. The Industrial Average had not sold at such a miniscule valuation since the depths of the Great Depression. This, I felt, strongly suggested the bottom.

The second chart (top of page 3) is a monthly high-low graph of the Dow showing the price movement going back to 1949. What interested me here, from the standpoint of the bear market's ending, was the three massive downward thrusts of the Dow. But upon closer examination it was clear that although each bear market smash was greater (in points lost) than the previous, the downward momentum seemed to be ebbing with each successive thrust. To prove this I have drawn an arc which connects points 1, 2 and 3. At point 3 in 1974 the arc appeared to "want to go" sideways. Furthermore, the range of point 3 was only 54 points below point 2, hardly an impressive figure when we consider that this was the third downward smash of a major bear market.

Studying the chart, it was clear that the bear had mounted three powerful lunges towards the lower depths. The third lunge seemed to have literally torn the market apart. Wall Street was reeling and (as stated above) stocks were selling at great value and in many, many cases below known value.

I was impressed by the fact that the bear market had come in three waves. Three often (but not always) completes a movement on Wall Street. At the 1974 lows the consensus was that the market had nowhere to go but "further down." The glaring contrary opinion, to my mind, was that the downside action was over. I believed it at the time. And I still feel that October-December marked the death of the great bear.

If so, if that is true, then a primary bull market began in late-1974. Despite the NYC tragedy, despite today's myriad business problems, despite the huge losses of W. T. Grant, the losses of many of the REITS and perhaps a number of NYC banks, I believe a bull market is on. The early stages of a bull market are often (if not usually) scary, unsure, indefinite. What we are seeing now is par for the course (comparable, perhaps to 1933). There may be, and probably will be, many false starts, scares, and shakeouts. But in the end the bull should have its way. And that, in my opinion, is the most important fact about the market today. (Chart of the Dow courtesy of Horsey, Salisbury, MD 21801).

NYC: In my opinion, NYC is the writing on the wall. It's the big beacon flashing for the entire country to see. NYC's pending default is a testiment to Bernard Baruch's simplest of all financial truisms: "Two and two always equals four."

As I stated in the last report, I consider the long-term effect of the NYC mess to be bullish for the nation. The pending NYC default serves notice for every corporate officer, every banker, every pension manager, every worker, that if you keep crowding the golden goose, eventually you push it right over the cliff. And that's exactly what has happened in NYC.

It may be that President Ford, Mr. Burns and Mr. Simon want to take the City away from the politicians. The politicians never had the guts to do what was needed, and it was probably impossible, politically, to do what had to be done. Default will give the courts authority to negate existing contracts, and that is crucial. All the damn fool, impossible, unworkable spending programs, the grandiose pension plans, the make-work jobs, they'll have to be revised or jettisoned. And already the "word" is spreading to other areas. Last week citizens in Ohio, New Jersey and New York State, voted down almost $6 billion in new bond issues. Solvency may be the watchword in the US again.

Mr. Ford is turning out to be a conservative. He recently stated that the Lockheed bailout may have been a "mistake." He indirectly blamed Mr. Rockefeller for some of New York's problems. Mr. Rockefeller's name is intertwined with NY's spending, and now Mr. Rockefeller is out. Defense Secretary Schlesinger was a big defense spender, and now he's walking. It could just be that Mr. Ford hears a certain loud voice from the grasslands, and that voice is saying, "Cut out the nonsense, stop the deficit binge, halt handouts."

Actually, history shows that no governmental agency has ever failed to pay off general obligation bonds. The initial shock of a NYC default has struck a primary bull market full in the face. We can be happy that all this occurred during a bull market. If the primary trend were currently bearish, if the worst had not already been discounted, my bet is that the Dow would be down about 200 points by now, and the nation's business would be reeling. So let's count our blessings. When the gods want to des-

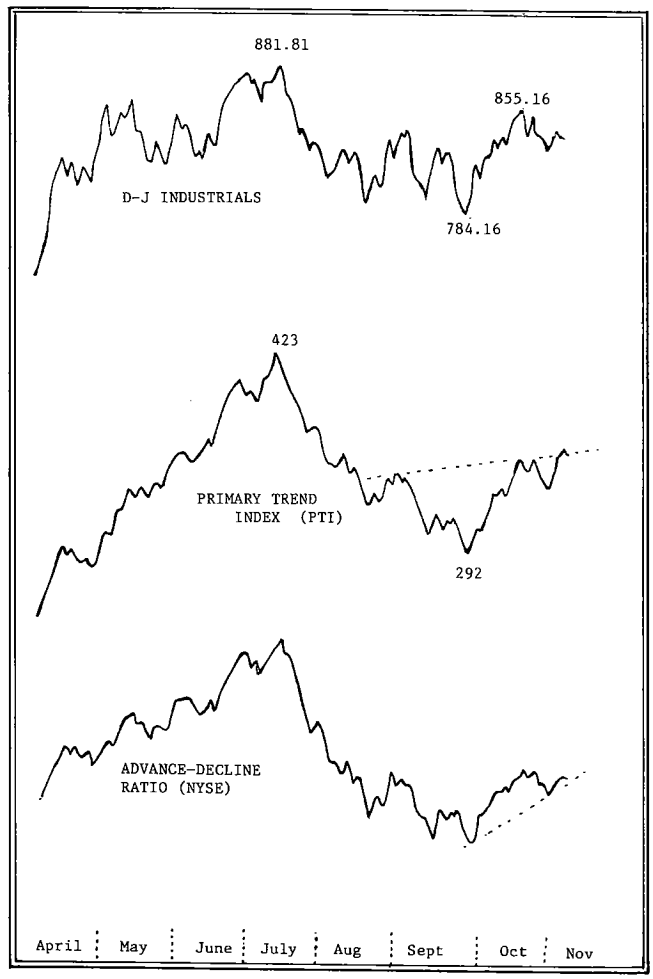
troy the markets, they'll make sure that the primary trend is bearish before they pull the plug!

At this point I'd like to include Tony Gaubis's comments about NYC and the market. Tony notes (as I have been noting) the many similarities between today and 1933 (remember, the market had discounted the worst at the 1932 bottom).

"Actually, default by New York City need not have any more serious consequences in Wall Street than did the closing of all of the country's banks in March, 1933. (During the first two months of 1933, stock prices declined as a result of both the series of bank closings and rumors that the newly elected President, Franklin Roosevelt, would close all of the banks immediately after his inauguration in early March. As things turned out, the Dow Industrials were 10% above their late February low on the day banks reopened in mid-March, and then advanced by more than 100% from their February low within the next four months.)"

The fact is (and I have been discussing this for months) that the nation is moving into a generally conservative and deflationary atmosphere. The white heat of inflation has simmered down. Business intensity has decreased all across the board. But during this period liquidity is building, and that is long-term bullish. The latest issue of the Bank Credit Analyst notes that "from a cyclical point of view, there has been a massive relative improvement in the banking system over the past year, and there is nothing to suggest that this improvement won't continue for a lengthy period."

MORE TECHNICAL DEVELOPMENTS: The accompanying chart shows the daily path of the Dow Industrials, the Primary Trend Index (PTI) and the A-D Ratio. The most interesting facet of this picture is the PTI, which has formed a very strong looking bottom, and seems to be "pushing up" while the Dow and even the A-D ratio are laggard. This could be a very hopeful sign, as I see it.



The PTI is an amalgam of eight critical technical indicators, and it is my single "secret" indicator. Only the composition of the PTI is secret, however, and the ingredients are as follows: The Three Dow Averages (Industrials, Transports, Utilities), the S & P 500 Stock Average, the D-J 40-Bond Average, the daily high and lows, the daily A-D ratio, and the daily most-active stocks. I have worked these averages and indices into a daily formula which traces the technical strength of the market.

Note that the PTI has formed a very solid up-standing "head-and-shoulders bottom." Furthermore, on Friday, November 7, despite a five point drop by the Dow, the PTI rose and broke out of the resistance line (dotted line) to the upside. This would seem to indicate that the technical underpinnings of this market as considerably stronger than appears on the surface.

My experience is that when the PTI leads on the upside, we have a situation which is potentially bullish. Furthermore, note that the A-D ratio has formed a rising trend from the September low, and although not as strong as the PTI, the A-D does seem to want to confirm on the upside.

The situation here is very much like the situation with the Dow and the Transport Average. The Dow Industrials haven't been able to move up convincingly, nor have they broken down in any convincing way. The PTI and the Transports have been rather convincing on the upside. If the bears throw in the towel and decide to halt their selling of the Dow issues, we could get quite a bull move on the Industrial Average. Meanwhile, the market, it seems to me, is continuing to play its nervous game of "consolidation."

STOCKS: I took out my Quote weekly charts over the weekend, and I must say that a study of hundreds of stock charts is most instructive at this time (Quote, PO Box 213, Wichita KS 67201). The stocks are simply going every which way. This is typical, I feel, of this stage of the bull market, a stage wherein the economy is sluggishly rising, in which many bullish and bearish cross-currents are present, a stage in which inflationary and deflationary forces are clashing, and a stage in which rampant pessimism has gripped the nation. In fact, in the face of subtly improving business conditions, a recent Gallup poll states that "if this (pessimistic) trend persists, it is within the realm of possibility that the United States will in the near future experience its greatest crisis of confidence since 1933." How about a contrary opinion here?

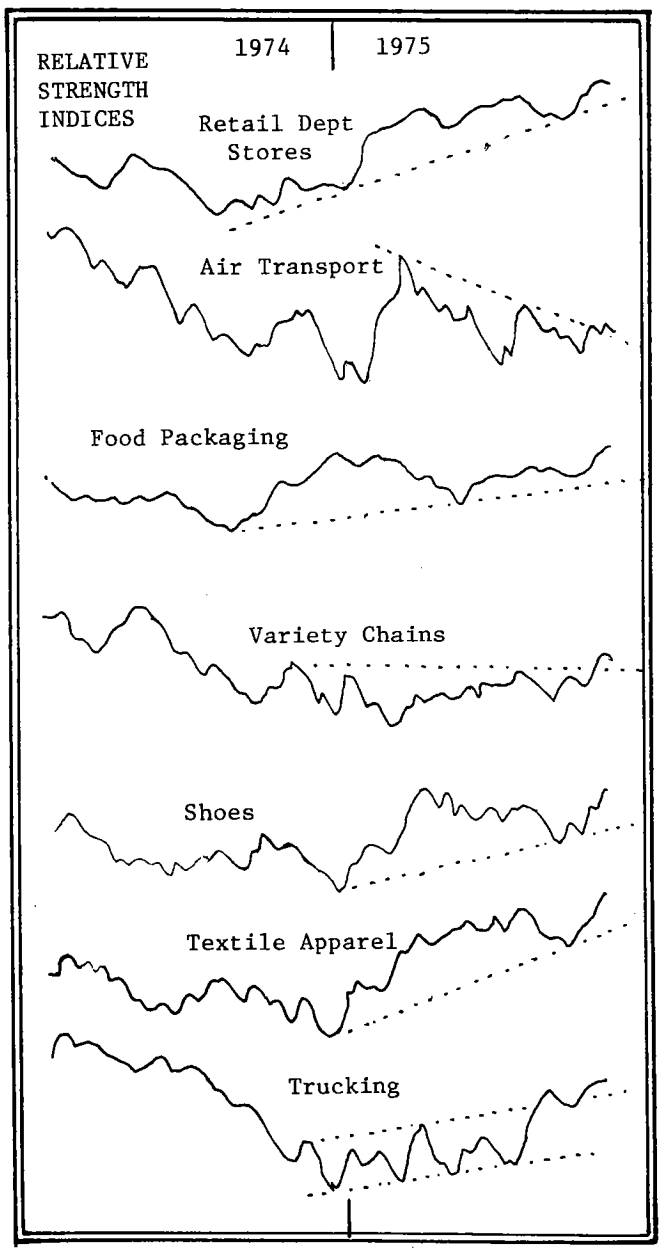
At any rate, on a dispassionate reading of the market, many stock groups are performing well in terms of relative strength (RS). I include a chart showing the relative strength lines of seven groups, six of which are performing bullishly and the seventh may be about to turn up. Remember, RS indicates the action of the group compared with the general market. RS is not a price value, it is a comparison. Thus, if the market is in an uptrend, these groups may be expected to retain their superior RS, and many of the stocks in each group may be expected to outperform the market.

In the Retail Group, JC Penney would be an interesting choice. In the Food Packaging group I like Quaker Oats. In Variety Chains I have liked and still like Woolworth. Brown Group is my choice in the Shoe Group. In Textiles I still think JP Stevens is a value. In Trucking, the laggard is Transcontinental Lines, but I feel this is a good speculation.

The Airlines look to me as if they "want to" turn up in RS, and on a short-term basis the Group has reversed its bearish trendline. A rank speculation such as PSA could prove to be interesting here, but as veteran market watchers know, the Airlines are a strange breed. They almost always go up or down together, regardless of individual standputs or failures. Thus, to make money in Airlines you have to get that timing right, and get in on a real "Airline market." The Transportation Average has been acting well enough, and what's happening to the Average could rub off on the Airlines.

To give readers an idea of value, PSA (after writing off everything) has a book value of around $21 a share. The stock has cash or equivalent of over $7 per share. This is no blanket recommendation of the stock, but it does indicate, I feel, that there is real potential for upward revaluation of this stock.

GOLD: Gold bullion, despite its flirting with an upward breakout on the momentum line (see last week's report), continues to act sluggish as do the shares. My opinion on the entire gold picture has not changed and remains luke-warm to negative. The chart below shows gold bullion fluctuating below its long-term or primary trendline. Silver, although acting better than gold, is also trending below its primary trendline.



Next mailing: November 21, 1975